DEPARTMENT OF STATE REVENUE

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Letter of Findings: 06-0349
Individual Income Tax
For the Year 2004

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ISSUE

I. Individual Income Tax - **Imposition.**

Authority: I.R.C. § 316; IC § 6-3-1-11; IC § 6-3-1-19; IC § 6-3-2-2; IC § 6-3-2-2.2; IC § 6-3-4-11; IC § 23-18-1-10; IC § 23-18-6-2; 45 IAC 3.1-1-38; Riverboat Development, Inc. v. Ind. Dep't of State Revenue, 881 N.E.2d 107 (Ind. Tax Ct. 2008); Rhoade v. Indiana Dept of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Miller Brewing Co. v. Indiana Dept. of State Revenue, Cause No., 2007 WL 1667128 (Ind. Tax Ct. June 8, 2007), aff'd 903 N.E.2d 64 (Ind. 2009); SAC Finance, Inc. v. Indiana Dep't of State Revenue, 894 N.E.2d 1116 (Ind. Tax Ct. 2008).

Taxpayer protests the imposition of Indiana income tax on income allotted to Taxpayer from a Kentucky S Corp - itself a member of an Indiana LLC that operates an Indiana riverboat gambling casino - of which Taxpayer is a shareholder.

STATEMENT OF FACTS

In 1993, the Indiana legislature passed laws that allowed riverboat gambling in the Hoosier state. In a November 1994 special election, a ballot proposal to approve legalized riverboat gambling along the Ohio river was passed by the residents of an Indiana county. A Kentucky subchapter S corporation ("Kentucky S Corp" or "S Corp") had helped finance this Indiana referendum. The Kentucky S Corp had joined another entity to bring a riverboat casino to Indiana. In May 1996, the Kentucky S Corp and the other entity were granted approval for a preliminary license to begin their joint project. The venture, in the form of an Indiana limited liability company ("Indiana LLC") carrying the name of both of its members, eventually brought to Indiana the largest riverboat casino in the world along with a hotel and entertainment resort complex.

Taxpayer, an individual, was a major shareholder of the Kentucky S Corp. Taxpayer was also, according to the Kentucky S Corp's certificate of authority to do business in Indiana, one of its two directors and its vice president and secretary. Taxpayer was also a director of the Indiana LLC.

For 2004, the Kentucky S Corp elected to be taxed as an S-corporation. Taxpayer, a non-resident, received a 2004 Indiana K-1 from the Kentucky S Corp allotting to Taxpayer over $800,000 of ordinary business income and $19 of ordinary dividend. The Kentucky S Corp's Indiana K-1 also allotted to Taxpayer over $4,000,000 resulting from the addback of Indiana gaming wagering tax payments previously deducted on the 2004 federal return. The Kentucky S Corp's only income was from the Indiana LLC's riverboat casino operations discussed above.

Taxpayer reported this Indiana business activity, as represented on the K-1, on his 2004 Indiana non-resident income tax return. Taxpayer, however, filed the Indiana return with the Indiana Department of Revenue (the "Department") under protest stating that he did not believe he owed Indiana the tax reported on the return and consequently did not remit the income tax. Taxpayer referred to Indiana litigation in which the Kentucky S corporation was involved on a matter that could impact Taxpayers Indiana income tax obligation. The Department assessed Taxpayer the reported but unremitted income tax, but stayed collection pending resolution of matters relating to this protest.

Once the related litigation terminated, Taxpayer's protest proceeded to hearing. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Individual Income Tax - **Imposition.**

DISCUSSION

Taxpayer's protest that he does not owe adjusted gross income tax to Indiana rests on his argument that the income attributed to him as a shareholder of the Kentucky S Corp is not Indiana source income.

Taxpayer claims that the riverboat gambling operations' income which passed from the Indiana LLC through to the Kentucky S Corp and then to him is not taxable by Indiana. Taxpayer argues that the taxable income of a nonresident is adjusted gross income derived from sources within Indiana (citing to IC § 6-3-2-1(b)). Taxpayer then cites to IC § 6-3-2-2(a) for the proposition that only income from intangible personal property attributed to Indiana under IC § 6-3-2-2.2 is taxable in Indiana. Taxpayer argues:

> IC § 6-3-2-2.2 delineates in considerable detail the categories into which income from intangibles must fall to be deemed to be attributable to Indiana under IC § 6-3-2-2(a)(5). The only category of income described in IC § 6-3-2-2.2 that related to investment income is subsection (g) on dividends which provides that dividends are attributable to Indiana if the commercial domicile of the taxpayer is in Indiana.

In presenting his argument, Taxpayer relies on Riverboat Development, Inc. v. Ind. Dep't of State Revenue,

881 N.E.2d 107 (Ind. Tax Ct. 2008). Taxpayer restates the Tax Court's opinion as follows:

> [T]he Tax Court held that "[g]iven the plain terms of Indiana's statutes, the income [Kentucky S Corp] received as a result of its membership interest in [Indiana LLC] [for the 1998-2002 taxable years] is not adjusted gross income derived from sources in Indiana. As a result, [Kentucky S Corp] was not subject to the withholding obligations... during the years at issue." The Tax Court reasoned that [Kentucky S Corp]'s income from its membership interest in [Indiana LLC]'s was income from an intangible that is required by the plain language of IC §§ 6-3-2-2 and 2.2 to be sourced to [Kentucky S Corp]'s commercial domicile, which was Kentucky.
>
> If, as the Tax Court held, [Kentucky S Corp]'s income from its membership interest in [Indiana LLC] was not Indiana source income, then its shareholders, such as the Taxpayer, cannot have Indiana source income.

Taxpayer makes two broad assertions in support of his protest. Taxpayer's first assertion is that he is a "mere owner of stock" in a Kentucky S Corp, by implication merely a passive investor in the Kentucky S Corp. The second assertion is that the income attributed to the Kentucky S Corp and then to him, is in the form of "dividends."

A. Taxpayer a "mere owner of stock" in an S corporation.

Taxpayer claims he "did no more than own stock in [Kentucky S Corp], a nonresident corporation that itself did not conduct business in Indiana, but merely owned a membership interest in [Indiana LLC]."

Taxpayer concludes his written protest by saying that he "simply made an investment in a Kentucky corporation" and that his "mere ownership of stock of [Kentucky S Corp], a separate entity, does not mean that the Indiana activities of [Indiana LLC] can be attributed to [Kentucky S Corp] and in turn to Taxpayer so as to give Indiana jurisdiction to tax Taxpayer."

IC § 6-3-2-2 states in relevant part:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
>
> (1) income from real or tangible personal property located in this state;
>
> (2) income from doing business in this state;
>
> (3) income from a trade or profession conducted in this state;
>
> (4) compensation for labor or services rendered within this state; and
>
> (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.
>
> (Emphasis added).

45 IAC 3.1-1-38 defines what "doing business" means:

> Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
>
> (1) Maintenance of an office or other place of business in the state
>
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
>
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
>
> (4) Rendering services to customers in the state
>
> (5) Ownership, rental or operation of a business or of property (real or personal) in the state
>
> (6) Acceptance of orders in the state
>
> (7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.
>
> As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n).
>
> (Emphasis added).

Pursuant to an administrative subpoena, Taxpayer provided the Department the Indiana LLCs most recent amended operating agreement dated December 28, 1999 ("Operating Agreement"). The Operating Agreement of the Indiana LLC was entered into by the Kentucky S Corp and it's the other LLC member. The first two pages of the Operating Agreement set out a series of recitals among which are the following relevant ones:

> WHEREAS, [the other Indiana LLC member] and [Kentucky S Corp] have formed [Indiana LLC] [...]
>
> WHEREAS, the investors in [Kentucky S Corp] desire to continue to pursue the venture contemplated herein with [the other Indiana LLC member];
>
> WHEREAS, the Members [the Kentucky S Corp and the other Indiana LLC member] have formed the Company [Indiana LLC] and have obtained a license from the Indiana Gaming Commission to permit the Company to own and operate a riverboat with gaming operations at or near [...] for the purpose of the development of such operations, including restaurants, hotels, entertainment facilities or other amenities as are deemed appropriate for the particular site [...];
>
> WHEREAS, [Kentucky S Corp] contributed to the Company options to acquire approximately 250 acres of

land at or near [...], Indiana, [...] and [the other Indiana LLC member] contributed cash to the Company

WHEREAS, [Kentucky S Corp] obtained a license for a riverboat gambling operation in [...] County, Indiana;

WHEREAS, [Kentucky S Corp] has received certain pre-development, development, and construction fees for services rendered on behalf of the Company;

[...]

WHEREAS, the Members desire to set forth their agreement for the conduct of the Company's affairs in writing.

According to Exhibit B of the Operating Agreement, the Kentucky S Corp holds 50 percent of the full voting units of the Indiana LLC and 18 percent of the limited voting units (see definitions of "Class A Units" and "Class B Units" in Article 1). Article 1 of the Operating Agreement defines "control" as follows:

"Control" (including the terms "controlling," "controlled by" and "under common control with") means the ownership or possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a Person, whether through the ownership of fifty percent (50%) of the voting securities, by contract or otherwise.

Article 4 of the Operating Agreement discusses management of the Indiana LLC. The general manager of Indiana LLC is either the other founding member or one if its corporate parents affiliated entities. The general manager has full and complete authority to manage Indiana LLC's business and operations unless matters specifically requiring the approval of the board of directors are involved. Matters reserved to the board of directors are discussed in Section 4.5 of Article 4 and include such matters as approval of the annual budget including budgeted distributions to Indiana LLC's members; material contracts; the sale, disposition or transfer of substantially all of Indiana LLC's assets; any financing to be obtained; formation of separate related entities; etc.

According to Section 4.3 of Article 4, the board of directors is comprised of representatives designated and appointed in equal number by the Kentucky S Corp and the other Indiana LLC member (otherwise referred to in the Operating Agreement as "Founding Members"). According to the Operating Agreement, the Founding Members each designated and appointed two people to sit on Indiana LLC's board of directors. Taxpayer was one of the two appointed directors of the Indiana LLC.

There is no question that S Corp was "doing business" in Indiana. The recitals and Articles above establish that the Kentucky S Corp was an integral participant in the introduction of riverboat gambling to southern Indiana and a founding member of the Indiana LLC that operated the riverboat. S Corp was furthermore involved in ongoing decisions integral to the operations of the Indiana LLC. Taxpayer was a major shareholder of the Kentucky S Corp. Taxpayer was one of two directors of the Kentucky S Corp, as well as its vice president and secretary. The Kentucky S Corp in turn, as one of the Indiana LLC's two founding members, appointed Taxpayer as a director of the Indiana LLC.

Accordingly, Taxpayer was more than a mere shareholder of a foreign S corporation that was a member of an Indiana LLC that happened to operate the largest riverboat gambling casino in the world and whose operations S Corp had a role in directing.

B. Dividends.

Irrespective of the above, the question remains whether or not the S Corp received "dividends" from the Indiana LLC which were sourced to Kentucky, the S Corp's domicile, rather than Indiana?

In concluding that his income is not sourced to Indiana, Taxpayer in essence presents the following logic:

S Corp made an investment in an Indiana LLC; S Corp's investment in the Indiana LLC creates its "membership interest"; a "membership interest" is intangible personal property; according to IC § 6-3-2-2, only income from intangible personal property attributed to Indiana under IC § 6-3-2-2.2 is taxable in Indiana; the only subsection of IC § 6-3-2-2.2 that mentions the word "investment" is subsection (g) which states that "[r]eceipts in the form of dividends from investments are attributable to this state if the taxpayer's commercial domicile is in Indiana"; therefore what S Corp receives from the Indiana LLC must be "dividends"; according to IC § 6-3-2-2.2(g), "dividends" are only attributable to Indiana if S Corp is in Indiana; since S Corp is domiciled in Kentucky, then the income from the "dividends" is not taxable in Indiana. Therefore, as a shareholder of the S Corp's stock, Taxpayer also does not have Indiana source income.

Taxpayer's logic rests on Riverboat Development, Inc.'s reliance on IC § 23-18-1-10 which defines a membership interest in a limited liability company as a "member's economic rights in the limited liability company, including the member's share of the profits and losses of the limited liability company and the right to receive distributions from the limited liability company." Riverboat states that pursuant to IC § 23-18-6-2 "[t]he interest of a member in a limited liability company is personal property." More specifically, Riverboat asserts "this interest constitutes intangible personal property." (citing Rhoade v. Indiana Dep't of State Revenue, 774 N.E.2d 1044, 1048 (Ind. Tax Ct. 2002).

Taxpayer believes that the Tax Court decision in Riverboat Development is dispositive of the issues protested because its own facts are similar if not identical to the facts previously considered by the Tax Court. The Department must respectfully disagree that the facts, circumstances, and issues considered by the Tax Court in Riverboat Development are identical to or necessarily dispositive of those presently under consideration and that the Department is now precluded from reconsidering those issues. As noted in Miller Brewing Co. v. Indiana Dept.

of State Revenue, Cause No., 2007 WL 1667128 (Ind. Tax Ct. June 8, 2007), aff'd 903 N.E.2d 64 (Ind. 2009), "[E]ach tax year stands alone to be assessed separately" and finding that the Department was free to relitigate the specified issue "so long as any such relitigation is done in good faith and not for purposes of harassment." Miller Brewing, 2007 WL 1667127 at *3.

That an interest relating to membership in a limited liability company is intangible personal property is obvious and beside the point. A person's "membership interest" in an LLC generally describes a person's ownership stake in that business entity. The "membership interest" itself is something the member owns, and as the owner of the interest, the member can sell the interest to another entity or person, or can otherwise transfer it. The "membership interest" gives its owner the right to distributions from the LLC when the LLC actually makes distributions, and for tax purposes obligates the owner of the interest, when the LLC elects partnership treatment, to annually report the particular owners portion of the LLC's income that was allocated to him either wholly or partially based on his proportionate "membership interest."

Therefore, the "membership interest" that Taxpayer refers to does not describe the actual business activity of the entity and has nothing to do with how the entity elected to report its business activities for tax purposes. The "membership interest" merely reflects the number of "units" (as described in the Operating Agreement) that the S Corp owns of the Indiana LLC.

For tax reporting purposes, an LLC with multiple members elects to be treated either as a partnership or as a corporation. When the LLC elects partnership treatment, then the particular "membership interest" determines, along with the operating agreement if one exits, how much of the business' activities will be allocated to each member for annual tax reporting purposes. The "membership interest," along with the operating agreement if one exists, determined the amount of any distributions the member is entitled to receive when and if any actual distributions are made.

In the alternative, if the LLC elects C corporation status, business activities of the LLC are reported for tax purposes as a C corporation. The "membership interest," and the operating agreement if it exists, only matter if actual distributions are made. If actual distributions are made by the LLC as a C corporation the distributions could be in the form of dividends.

In 2004, the Indiana LLC elected partnership treatment for its federal and state tax reporting purposes.

Taxpayer cites to Riverboat Development, Inc. and argues that its income is analogous to that earned by an investor from stock dividends. However, Taxpayer's argument misses two important points.

First, the term "dividend" upon which Taxpayer seeks to analogize the Kentucky S Corps interest in a limited liability company, is a term which has been expressly defined by federal tax law. See I.R.C. § 316. By its very definition, a "dividend" is a "distribution of property made by a corporation to its shareholders [out of earnings and profits]" and can only be made by a C corporation or another entity that elects to be taxed as a C corporation. I.R.C. § 316(a). This definition has been incorporated into Indiana's tax code. See IC § 6-3-1-11. The income in question was derived from a limited liability company doing business in Indiana. That limited liability company elected to be treated as a partnership for federal tax purposes. The limited liability company never was a C corporation. Thus, the limited liability company could not have dividends within the meaning of federal and state tax law.

Second, the limited liability company is included in the definition of "partnership" as provided in IC § 6-3-1-19. Indeed, the very act that created limited liability companies under Indiana law also amended the definition of "partnership" to specifically include limited liability companies. Under IC § 6-3-4-11, partnerships are exempt from Indiana income tax; however, "persons or corporations carrying on their business as partners shall be liable for the adjusted gross income tax only in their separate or individual capacities." Taxpayer's argument–that the Kentucky S Corp can somehow recharacterize its income by providing a layer or layers between itself and the individual or other entity responsible for the tax–effectively renders IC § 6-3-4-11 meaningless. The legislature cannot be presumed to have created a statutory provision that is meaningless. SAC Finance, Inc. v. Indiana Dep't of State Revenue, 894 N.E.2d 1116, 1120 (Ind. Tax Ct. 2008) (citing U.S. v. Powers, 307 U.S. 214, 217, 59 S.Ct. 805, 83 L.Ed. 1245 (1939)).

If Taxpayer wished to merely receive dividends from a stock investment, Taxpayer should have either invested in a C corporation. Alternatively, Taxpayer, a major shareholder of the Kentucky S Corp, should not have approved the S election for this entity.

Furthermore, if as Taxpayer argues, the income of the Kentucky S Corp was not taxable in Indiana because it was in the form of "dividends"– which are not taxable in Indiana according to Taxpayer, because Indiana is not where S Corp is domiciled– then presumably, the Kentucky S Corp's "dividend" income should have been allocated to Kentucky which is S Corp's domiciliary state. The S Corp's 2004 Kentucky return, however, shows no such income allocated to Kentucky. Furthermore, the S Corp would have received a Kentucky K-1 from the Indiana LLC.

Apparently, in Taxpayer's view, the Kentucky S Corp of which he is a major shareholder had income that was not reportable in any state. This view stands in further contrast to the Kentucky S Corp's ready acceptance of the losses that the Indiana LLC allotted to it in prior years.

In conclusion, Taxpayer has not shown sufficient evidence to support his protest that he is not subject to the

imposition of Indiana adjusted gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

Posted: 08/26/2009 by Legislative Services Agency
An html version of this document.